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SUBJECT: IRAQ LACKS CAPACITY FOR OIL TRUST FUND

REF: 02/13/2009 Shapiro/Wall e-mail

¶1. (SBU) Summary: A common mechanism to manage revenue from natural resources is the establishment of a form of natural resources fund, such as an "oil trust fund." However, Iraq currently does not have the resources or capacity to establish such a stabilization fund. The Government of Iraq's (GOI) struggle to adjust its 2009 budget to the drop in global oil prices shows it has little flexibility. As a legacy of the UN controls over the Coalition Provisional Authority (CPA), Iraq currently has the Development Fund for Iraq (DFI) into which oil revenues are deposited and from which government expenditures are paid. The bilateral Strategic Framework Agreement provides a process whereby the U.S. can pursue post-DFI mechanisms with the GOI, including the near-term priority of a stabilization fund and the potential future benefits of a distributive fund. End Summary.

A Natural Resource Fund

¶2. (U) Many resource rich countries have devised mechanisms to manage revenue from their natural resources, including establishment of an "oil trust fund." Such a fund can take several forms - stabilization, savings, or distributive. A stabilization fund is designed to shield the national budget from revenue uncertainty and volatility for limited periods. A savings fund creates a store of wealth for present and/or future generations and receives a constant share of oil revenues that is held for future distribution or investment, especially when oil resources are exhausted. A distributive fund disburses oil revenues within a limited timeframe and is not structured to provide explicit intergenerational transfers. Trust funds can also be hybrids that combine two or all three of the main forms. An oil trust fund for Iraq could also be a way to resolve the political stalemate over revenue distribution.

Oil Revenues and DFI

¶3. (SBU) As a legacy of the UN controls over the CPA, Iraq currently has the Development Fund for Iraq (DFI) into which oil revenues are deposited and from which government expenditures are paid. The immunities and international oversight associated with the DFI will expire on December 31, 2009. The Government of Iraq will need to consider a mechanism to substitute when the DFI expires. Since over 90% of government revenues come from oil exports, Iraq must first reduce the impact of price volatility as well as invest heavily in its energy infrastructure, which points to the need for a stabilization fund before a distributive fund. However, because Iraq currently does not have the resources or capacity to implement even a stabilization fund, discussions should be focused towards long-term planning.

¶4. (SBU) The GOI's struggle to adjust its 2009 budget to the drop in oil prices shows the government's lack of flexibility in what is essentially a one export economy. Its budget programs a \$16 billion deficit by assuming 2 million barrels per day in oil exports at \$50 per barrel. The first two months of 2009, oil revenues were \$3.7 billion, or \$2.2 billion below budget assumptions. Oil prices

averaged \$39.69 per barrel. Thus, the deficit could likely be much greater than budgeted predictions and absorb most of the GOI's accumulated fiscal balances. The Ministry of Finance hopes to diversify its revenue by expanding its domestic Treasury bill offerings in the short term and improving its tax collection. Nevertheless, should oil prices and/or oil output remain stagnant or decline, Iraq will have fewer resources to finance large deficits in Qdecline, Iraq will have fewer resources to finance large deficits in 2010 and beyond. Iraq will not have enough revenue to establish any type of fund. The GOI faces difficult budget cuts, which could have destabilizing influences on Iraq's fragile economic recovery.

Current Revenue-Sharing Mechanisms

¶5. (SBU) So far, the lower price of oil has not pushed Erbil or Baghdad to compromise on revenue sharing or hydrocarbons legislation, which would establish a new framework for transparent management of the oil and gas industry. The revenue sharing bill is centered on the entire budget process. According to the June 2007 draft, the Kurdistan Regional Government views revenue sharing as taking place before the national budget and thereby completely avoiding either the Ministry of Finance or parliament. The central Government of Iraq views that revenue sharing will be handled through the national budget. Since neither side is willing to concede or compromise on its view on revenue sharing, the two sides have primarily focused on resolving the hydrocarbons law.

¶6. (U) In the absence of a formal revenue sharing law, oil income is nevertheless shared. The Iraqi budget de facto distributes revenue directly to the Kurdistan Region and all provincial governments. The Kurdistan Region has received 17% of the Iraqi budget since ¶2003. The distribution to the provinces has occurred every year

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since 2006 based on population estimates. From 2006 to 2009, the GOI allocated \$12.8 billion directly to provincial governments for investment projects to improve infrastructure and delivery of essential services to the Iraqi people. Furthermore, while not exactly the same as an oil trust fund, the GOI provides a basket of goods to all Iraqis via the Public Distribution System (PDS). From 2005 to 2009, the GOI allocated \$18.9 billion for the PDS.

The Way Forward

¶7. (SBU) The Strategic Framework Agreement provides a process whereby the U.S. can pursue post-DFI mechanisms with the GOI, including the near term priority of a stabilization fund and the potential future benefits of a distributive fund. The Economic and Energy Joint Coordination Committee, established in the agreement, provides an opportunity to promote GOI outreach to such experts as the World Bank and the Government of Norway. The World Bank has expertise in establishing resource funds, and has also expressed an interest in helping design a post-DFI mechanism. The Government of Norway has provided assistance to other countries developing natural resource funds.

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